CHAPTER 6

Commerce and Economic Development Bureau

Hong Kong Export Credit Insurance Corporation

Audit Commission
Hong Kong
31 March 2011

This audit review was carried out under a set of guidelines tabled in the Provisional Legislative Council by the Chairman of the Public Accounts Committee on 11 February 1998. The guidelines were agreed between the Public Accounts Committee and the Director of Audit and accepted by the Government of the Hong Kong Special Administrative Region.

Report No. 56 of the Director of Audit contains 8 Chapters which are available on our website at http://www.aud.gov.hk.

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HONG KONG EXPORT CREDIT INSURANCE CORPORATION

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PART 1: INTRODUCTION

1.1 This PART describes the background to the audit and outlines the audit objectives and scope.

Background

1.2 The **Hong Kong Export Credit Insurance Corporation** (**ECIC**) was established in 1966 under the ECIC Ordinance (Cap. 1115). It aims to encourage and support Hong Kong's export trade by providing exporters of goods and services, who offer credit terms to overseas buyers and clients, with insurance protection against non-payment risks arising from commercial and political events. The two main types of non-payment risks insured are:

(a) buyer risks which include bankruptcy or insolvency, payment default and refusal to take delivery of goods; and

(b) country risks which include blockage or delay in foreign exchange remittance, import ban, cancellation of import licence, payment moratorium, and war, revolution, riot or natural disaster.

1.3 Over the years, the ECIC has made contributions to Hong Kong's economy by providing insurance protection to the exporters. As can be seen in Table 1, the amount of insured business increased from $35,557 million in 2005-06 by $28,591 million (80.4%) to $64,148 million in 2009-10.

Table 1

**Financial performance of the ECIC
(2005-06 to 2009-10)**

	2005-06 ($ million)	**2006-07 ($ million)**	**2007-08 ($ million)**	**2008-09 ($ million)**	**2009-10 ($ million)**
Insured business	35,557	39,299	42,947	47,180	64,148
Underwriting income/(loss)(a)	69.21	47.10	44.06	(0.30)	25.91
Investment income/(loss)(b)	48.71	67.75	99.35	(29.60)	90.32
Profit/(loss)(c) (c) = (a) + (b)	117.92	114.85	143.41	(29.90)	116.23
Capital and reserves as at the end of the year	892.44	1,026.84	1,163.12	1,091.28	1,256.77

Source: ECIC records

1.4 The Government made two capital injections of $10 million each to the ECIC in 1966 and 1974 respectively. As at 31 December 2010, the ECIC's capital remained at $20 million. In accordance with the ECIC Ordinance, the payment of all moneys due by the ECIC in respect of losses and claims which may arise under its contracts of insurance is guaranteed by the Government. As at 31 December 2010, the maximum limit of such guarantee as approved by the Legislative Council (LegCo) was $30 billion.

1.5 The ECIC does not receive any government subvention. It is required under the ECIC Ordinance to pursue a policy directed towards securing revenue sufficient to meet all expenditure properly chargeable to its revenue account. As shown in Table 1, for 2009-10, the ECIC made a profit of $116.23 million, comprising an underwriting income of $25.91 million (22.3%) and an investment income of $90.32 million (77.7%). As at 31 March 2010, the ECIC's capital and reserves amounted to $1,256.77 million.

1.6 The **Commerce and Economic Development Bureau** (**CEDB** — Note 1) has the overall policy responsibility for the ECIC's work. To advise the ECIC in the conduct of its business, an Advisory Board was established under the ECIC Ordinance. As at 31 December 2010, the ECIC had 115 staff, headed by a Commissioner appointed by the Secretary for Commerce and Economic Development under the delegated authority of the Chief Executive. An organisation chart of the ECIC is at Appendix A.

The 1992 audit of the ECIC

1.7 Under section 26 of the ECIC Ordinance, the Director of Audit may examine the accounts of the ECIC. In March 1992, the Audit Commission (Audit) reported the results of a value for money audit on the determination of the ECIC's capital and reserves, and the uses of its surplus (Director of Audit's Report No. 18 of March 1992). In the audit review, Audit made a number of recommendations for improvement (see para. 3.4). The Public Accounts Committee considered the Audit Report and included its recommendations in its Report of June 1992. The Administration subsequently implemented the recommendations.

Audit review

1.8 The ECIC plays an important role in supporting Hong Kong's export trade. According to the ECIC, amid the global financial crisis in the second-half of 2008 and in 2009 when commercial insurers reduced their cover drastically, the ECIC continued to extend its cover and recorded significant increases in its total exposure.

1.9 Given that the Government provides the ECIC with a substantial amount of guarantee ($21.5 billion as at 31 March 2010), Audit has recently conducted another review of the ECIC. The audit has focused on the following areas:

(a) corporate governance (PART 2);

(b) capital and reserves (PART 3);

(c) export credit insurance (PART 4);

(d) human resource management (PART 5); and

(e) financial and administrative issues (PART 6).

Audit has found that there is room for improvement in the above areas and has made a number of recommendations to address the issues.

Note 1: *Following the reorganisation of the Government Secretariat in July 2007, the CEDB was established to take over the policy responsibilities of the then Commerce, Industry and Technology Bureau. The Commerce, Industry and Technology Bureau is referred to as the CEDB in this Report.*

General response from the Administration

1.10 The **Secretary for Commerce and Economic Development** generally agrees with the audit recommendations and considers that the value for money audit on the operation of the ECIC helps further enhance the governance and operation of the ECIC.

General response from the ECIC

1.11 The **Commissioner, ECIC** generally agrees with the audit recommendations and appreciates the review conducted by Audit. He has said that:

(a) the ECIC is fully committed to encouraging and supporting the export trade, while upholding high principles in corporate governance. An Internal Audit Unit and an Audit Committee under the Advisory Board were set up in February 2010 and February 2011 respectively;

(b) throughout the years, the ECIC has introduced new management systems and workflows, code of conduct and clear authority matrix to facilitate smart management and compliance to established policies and procedures. The ECIC strongly believes in continual improvement and focuses especially in bringing in more transparency and accountability to the organisation; and

(c) a special Advisory Board meeting was held on 17 February 2011 to discuss the ECIC's response to the observations and recommendations mentioned in this Audit Report. After full consultation with the CEDB and the Advisory Board, the ECIC will develop new measures in response to those audit recommendations which cannot be implemented immediately. For improvements which can be made immediately, the ECIC has already implemented the necessary measures. The ECIC will keep the CEDB and the Advisory Board informed of the progress of implementation.

Acknowledgement

1.12 Audit would like to acknowledge with gratitude the full cooperation of the staff of the CEDB and the ECIC during the course of the audit review.

PART 2: CORPORATE GOVERNANCE

2.1 This PART examines issues relating to corporate governance.

Governance structure of the ECIC

Advisory Board

2.2 The ECIC is required to operate in accordance with the requirements laid down in the ECIC Ordinance. Under the Ordinance, the powers, functions and duties of the ECIC may be exercised or performed in its name and on its behalf by the Commissioner. An Advisory Board was established under the Ordinance to advise the ECIC in the conduct of its business. According to the Ordinance, the Advisory Board shall consist of:

(a) the Commissioner of Insurance, or his representative;

(b) the Executive Director, Hong Kong Trade Development Council, or his representative; and

(c) not more than 10 other members who shall be appointed by the Chief Executive (Note 2) for a term not exceeding three years at a time.

2.3 The Advisory Board is not a governing board of the ECIC. Under the ECIC Ordinance, the ECIC shall not be bound by the advice of the Board. As at 31 December 2010, the Board had 12 members comprising the 2 ex-officio members (see para. 2.2(a) and (b)), 1 Principal Assistant Secretary of the CEDB and 9 other members from the finance, insurance, and trade and industry sectors.

Committees

2.4 There is no specific provision in the ECIC Ordinance for the establishment of committees under the Advisory Board. In December 1998, an Investment Committee was established as a sub-committee of the Advisory Board to advise the ECIC in the conduct of its investment matters and to maintain closer monitoring on the performance of the ECIC's fund management. As at 31 December 2010, there were five Advisory Board members in the Investment Committee. To strengthen the ECIC's corporate governance, an Audit Committee composed of four Advisory Board members was established in February 2011.

Note 2: *The Chief Executive's authority to appoint members of the Advisory Board has been delegated to the Secretary for Commerce and Economic Development.*

Government's monitoring mechanism

2.5 The Government monitors the work and performance of the ECIC mainly through the following mechanism:

(a) representation in the Advisory Board by a Principal Assistant Secretary of the CEDB and the Commissioner of Insurance or his representative;

(b) half-yearly housekeeping meetings between the CEDB and the ECIC, which are chaired by the Permanent Secretary for Commerce and Economic Development (Commerce, Industry and Tourism). At the meetings, the ECIC reports to the Permanent Secretary on its financial performance, the utilisation of the statutory maximum guarantee, human resource matters and the overall situation in the export credit insurance industry; and

(c) the ECIC's annual report, which reports the business and financial performance of the ECIC, is approved by the Secretary for Commerce and Economic Development before it is tabled in LegCo.

Audit observations and recommendations

2.6 Audit considers that there is a need for the Government to regularly review the ECIC's governance and the CEDB's monitoring mechanism, because:

(a) ***Rapid business expansion.*** The business volume of the ECIC has grown substantially. In the past 20 years, the insured business of the ECIC had increased from \$14 billion in 1990-91 to \$64 billion in 2009-10, and the maximum limit of government guarantee had increased from \$7.5 billion as at 31 March 1991 to \$30 billion as at 31 March 2010. As mentioned in paragraph 1.9, the government guarantee as at 31 March 2010 stood at \$21.5 billion;

(b) ***Role of the Advisory Board.*** As mentioned in paragraph 2.3, the Advisory Board is not a governing board of the ECIC. Although the CEDB informed Audit that the ECIC had followed and implemented all advice provided by the Board, the ECIC Ordinance provides that the ECIC is not bound by the Board's advice. Owing to the limited role of the Advisory Board, coupled with the fact that there were no guidelines setting out the types of issues that should be submitted to the Advisory Board for information, discussion or endorsement (see para. 2.14), the CEDB plays an important part in monitoring the work and performance of the ECIC and overseeing its governance;

(c) ***Role of the CEDB.*** General Circular No. 8/2008 of December 2008 on Governance of Government-owned or Funded Statutory Bodies has pointed out that policy bureau has a role and responsibility to ensure that there are adequate reporting and monitoring systems for internal control and transparency. Audit noted that although the ECIC's annual corporate plans/budgets are endorsed by the Advisory Board (see para. 2.10), in which two members are government representatives, they are not required to be formally approved by the Government;

(d) ***Scope of the ECIC's services under the ECIC Ordinance.*** Section 9(3) of the ECIC Ordinance provides that the ECIC shall not enter into contracts of insurance against risks that are normally insured with commercial insurers. When the ECIC was established in 1966, it was the sole provider of export credit insurance for small and medium enterprises (SMEs). According to the ECIC, nowadays there are commercial insurers offering export credit insurance cover in Hong Kong. The CEDB needs to ensure that the ECIC operates in accordance with the requirements laid down in the ECIC Ordinance (see paras. 4.54 to 4.58);

(e) ***Monitoring of the ECIC's work and performance.*** The ECIC reports to the CEDB its financial and business performance at the half-yearly housekeeping meetings. According to the CEDB, it assesses the extent to which the ECIC has discharged its public mission through reviewing the amount of export business insured, the number of insured policies, and the scope of the ECIC's insurance coverage. However, the CEDB may need to consider further enhancing its monitoring of how effective the ECIC discharges its public mission; and

(f) ***Administrative irregularities identified***. In 2009, a consultancy study on the ECIC's internal control procedures identified irregularities in some of the outsourcing contracts (see paras. 6.13 and 6.14). Although both the CEDB and the ECIC have stepped up the control on the ECIC's corporate governance, they need to regularly review and further enhance the ECIC's corporate governance.

Audit recommendations

2.7 **Audit has *recommended* that the Secretary for Commerce and Economic Development should, in collaboration with the Commissioner, ECIC:**

(a) **regularly review the ECIC's governance and the CEDB's monitoring mechanism over the ECIC's work and performance;**

(b) **consider how the CEDB should further evaluate the ECIC's performance (e.g. setting appropriate outcome-oriented performance indicators) to ensure that the latter has effectively discharged its public mission of supporting export trade; and**

(c) **oversee the proper follow-through of the audit recommendations in this Report.**

Response from the Administration

2.8 The **Secretary for Commerce and Economic Development** agrees with the audit recommendations. She has said that:

(a) in collaboration with the ECIC, the CEDB will review the governance and the monitoring mechanism over the ECIC's work and performance;

(b) while the CEDB currently does not micromanage the daily operations of the ECIC, the CEDB requires the ECIC to seek advice from it and the Advisory Board, and approval from the CEDB on a wide range of issues in accordance with the ECIC Ordinance and established procedures. According to the ECIC Ordinance, the ECIC shall seek the approval of the Chief Executive, the Financial Secretary or the Secretary for Commerce and Economic Development (under delegated authority) on issues such as changes to its methodology in determining its contingency reserve, amendments to its investment guidelines, and changes to its scope of services. Besides seeking the CEDB's approval in areas required by law, the ECIC also consults the CEDB from time to time on new measures and services to encourage and support the export trade by providing Hong Kong's exporters with insurance protection against non-payment risks arising from commercial and political events. During the global financial crisis in 2008-09, the ECIC worked closely with the CEDB in devising and implementing enhancement measures such as waiving the annual policy fee and offering free buyer credit assessments to facilitate the needs of the export sector, especially SMEs;

(c) the performance of the Commissioner is appraised annually by an Assessment Committee chaired by the Chairman of the Advisory Board and attended by Board members. The report of the Assessment Committee has to be approved by the CEDB;

(d) the ECIC has made regular reports on how it discharges its public mission via the release of the annual report in the public domain. The ECIC has introduced a number of performance pledges since 1993 and reports to the CEDB on a half-yearly basis its achievement against its performance pledges. The ECIC has also set key performance indicators as its internal performance measures and reports to the Advisory Board its achievement against such measures. That said, the CEDB will consider how the reporting of the ECIC's performance regarding the discharge of its public mission can be further enhanced; and

(e) the CEDB will ensure that the audit recommendations will be properly followed up just as it did in following up the audit recommendations in the 1992 Audit Report (see para. 1.7).

Strategic planning

2.9 Effective strategic planning is vital to an organisation in meeting new demands and the challenges of a changing environment. An organisation needs to review its business objectives, examine its strengths, weaknesses, market position and strategic direction regularly, and develop a strategic plan for establishing what it intends to achieve over a period of time.

Audit observations and recommendation

2.10 The ECIC prepares a corporate plan annually setting out the programmes and activities, financial forecast and budget for the coming financial year. The annual corporate plan is submitted to the Advisory Board in March each year for its endorsement. However, the ECIC does not prepare any strategic plan covering a medium to long-term period (say three to five years) setting out its strategic objectives and direction. A good strategic planning would enable the ECIC to:

(a) plan ahead strategically for a longer term of three to five years;

(b) engender a culture which is forward thinking, innovative and can stimulate cooperation among different functions; and

(c) think positively and flexibly about the export and insurance markets in a proactive way.

In line with good governance practices, Audit considers it desirable for the ECIC to draw up a medium to long-term (e.g. three to five years) strategic plan.

Audit recommendation

2.11 **Audit has *recommended* that the Commissioner, ECIC should consider drawing up a strategic plan covering a medium to long-term period to set out the ECIC's mission, vision, strategic objectives and key result areas to be achieved.**

Response from the ECIC

2.12 The **Commissioner, ECIC** agrees with the audit recommendation. He has said that:

(a) in the wake of the global financial crisis, in September 2009, the ECIC reviewed its post-crisis positions and strategies; and

(b) since November 2010, the ECIC has commenced the discussion for a three-year strategic plan. The first rolling three-year plan and the annual corporate plan will be tabled for endorsement by the Advisory Board in 2011.

Board and Committee meetings

2.13 The Advisory Board and the Investment Committee normally hold three and four meetings a year respectively. From 2007 to 2010, 13 Advisory Board meetings and 16 Investment Committee meetings were held.

Audit observations and recommendations

Submission of issues to Advisory Board and Investment Committee

2.14 Audit noted that the ECIC submitted to the Advisory Board and the Investment Committee routine agenda items such as quarterly business and investment performance. However, non-routine agenda items were submitted solely at the discretion of the Commissioner. There were no guidelines setting out the types of issues that should be submitted to the Advisory Board or the Investment Committee for information, discussion, or endorsement. For example, some modifications on the reinsurance arrangement made in 2006 and 2007 were not reported to the Advisory Board (see paras. 4.50 and 4.51). To ensure that the Advisory Board or the Investment Committee is informed of significant issues in a timely manner, the ECIC needs to establish proper guidelines for determining the types of issues and the proper time frame for submission to the Advisory Board and the Investment Committee.

Attendance of members at Board/Committee meetings

2.15 The overall effectiveness of the Advisory Board and the Investment Committee in fulfilling their responsibilities is largely dependent on the members' knowledge, experience, competency and, most important of all, their commitment to attend the Board/Committee meetings. An examination of the attendance records for 2007 to 2010 revealed that the attendance of some members was on the low side. Details are as follows:

(a) ***Advisory Board meetings.*** From 2007 to 2010, 19 members served in the Advisory Board. The overall attendance rates of 3 members (Members A, B and C) for the period were 29%, 42% and 46% respectively (see Table 2); and

Table 2

Attendance rates of three members at Advisory Board meetings (2007 to 2010)

Member	2007	2008	2009	2010	Overall
A	50%	0%	50%	N/A (Note)	**29%**
B	0%	67%	25%	67%	**42%**
C	67%	33%	25%	67%	**46%**

Source: Audit analysis of ECIC records

Note: Member A retired from the Advisory Board in June 2009.

(b) ***Investment Committee meetings.*** From 2007 to 2010, nine members served in the Investment Committee. The overall attendance rates of two members (Members A and D) for the period were 43% and 33% respectively (see Table 3).

Table 3

Attendance rates of two members at Investment Committee meetings (2007 to 2010)

Member	2007	2008	2009	2010	Overall
A	100%	50%	0%	N/A (Note 1)	**43%**
D	N/A (Note 2)	N/A (Note 2)	50%	25%	**33%**

Source: Audit analysis of ECIC records

Note 1: Member A retired from the Investment Committee in June 2009.

Note 2: Member D joined the Investment Committee in July 2009.

Procedures for Board/Committee meetings

2.16 It is a good governance practice for an organisation to define clearly the working procedures for its board and committee meetings. The procedures should be properly documented and promulgated to all members. Audit noted that the ECIC had not laid down detailed procedures governing the proceedings of the Advisory Board/Investment Committee meetings (e.g. frequency of meetings, quorum requirements and timing for submission of discussion papers). In response to Audit enquiry in July 2010, the ECIC promulgated the Rules and Procedures for Advisory Board Meetings and the Rules and Procedures for Investment Committee Meetings in August and October 2010 respectively.

Submission of Board/Committee papers

2.17 According to good governance practices, an organisation should ensure that board/committee members are provided with all the information that they need to properly consider the issues to be discussed at a board/committee meeting, in good time before the meeting. In December 2010, the ECIC informed Audit that from 2007 to 2010:

(a) Board papers were required to be delivered to members at least seven days before the meeting; and

(b) Committee papers were required to be delivered to members before the meeting (but the number of days before the meeting was not specified).

2.18 Audit examined the submission of Board/Committee papers from 2007 to 2010. Audit noted that:

(a) 12 (19%) of 63 Advisory Board papers were delivered to members less than seven days before the meetings; and

(b) 17 (39%) of 44 Investment Committee papers were delivered to members less than seven days before the meetings.

Guide to corporate governance

2.19 In recent years, Audit has conducted a number of reviews on subvented organisations and found inadequacies in their corporate governance. To help address the concerns raised in the Audit Reports, the Efficiency Unit issued in May 2010 a "Guide to Corporate Governance for Subvented Organisations". The Guide sets out the principles and best practices relating to corporate governance and advises on matters that have raised concerns. It helps subvented organisations to assess their current performance and decide whether changes need to be made (Note 3). Audit considers that the ECIC needs to draw on the best practices contained in the Guide to establish its own arrangements.

Note 3: *The Guide aims primarily at organisations which receive recurrent subventions from the Government. Nevertheless, organisations which receive capital grants, non-cash concessions or one-off payments, and companies in which the Government holds shares are also encouraged to refer to the best practices promulgated in it.*

Audit recommendations

2.20 **Audit has *recommended* that the Commissioner, ECIC should:**

(a) **in consultation with the Secretary for Commerce and Economic Development, consider establishing guidelines for determining the types of issues (and the proper time frame) for submission to the Advisory Board (and its sub-committees) for endorsement, taking into account the outcome of the CEDB's review as mentioned in paragraph 2.7(a);**

(b) **take measures to improve the attendance of members at Advisory Board/Investment Committee meetings;**

(c) **ensure that the Rules and Procedures for Advisory Board and Investment Committee meetings promulgated in August and October 2010 respectively are properly complied with;**

(d) **ensure that Advisory Board/Investment Committee papers are submitted to members in good time before the meetings; and**

(e) **enhance the ECIC's corporate governance with reference to the best practices contained in the Efficiency Unit's "Guide to Corporate Governance for Subvented Organisations".**

Response from the ECIC

2.21 The **Commissioner, ECIC** agrees with the audit recommendations. He has said that the ECIC:

(a) has consulted the CEDB and will draw up guidelines for implementation in 2011-12 to determine the non-routine issues which should be submitted to the Advisory Board for endorsement;

(b) regularly reminds members of their attendance records and will consider other measures (such as installing video-conferencing/phone-in facilities) to facilitate members' participation in the Advisory Board's discussions. Members who are absent for two consecutive meetings or have attendance below 50% will receive a written reminder from the secretary to the Advisory Board;

(c) will review if the Rules and Procedures for Advisory Board and Investment Committee meetings have been complied with and submit annual reports to the Board and the Committee;

(d) has been following strictly the established time frame for submission of papers to the Advisory Board, except in unforeseen circumstances. For the Investment Committee, papers should be issued three days before the meeting. For late papers, the Chairman will decide at the meeting whether they should be deferred to the next meeting; and

(e) has been making reference to the "Guide to Corporate Governance for Subvented Organisations". Over 90% of the best practices in the Guide have been implemented by the ECIC. It will consider how best to further implement the remaining best practices.

PART 3: CAPITAL AND RESERVES

3.1 This PART examines issues relating to capital and reserves.

Increase in capital and reserves

3.2 The total amount of capital and reserves (equivalent to net assets) of the ECIC increased substantially from $892.44 million as at 31 March 2006 by $364.33 million (40.8%) to $1,256.77 million as at 31 March 2010 (see Table 4).

Table 4

Capital and reserves
(2006 to 2010)

	31.3.2006 ($ million)	**31.3.2007 ($ million)**	**31.3.2008 ($ million)**	**31.3.2009 ($ million)**	**31.3.2010 ($ million)**
Capital	20.00	20.00	20.00	20.00	20.00
Contingency reserve (Note 1)	513.40	555.76	637.68	687.33	1,039.47
Non-insurance reserve (Note 2)	52.47	54.58	61.88	67.31	70.91
Fair value reserve (Note 3)	34.89	54.43	47.30	5.36	54.62
Retained earnings	271.68	342.07	396.26	311.28	71.77
Total	**892.44**	**1,026.84**	**1,163.12**	**1,091.28**	**1,256.77**

Source: ECIC records

Note 1: The contingency reserve was set up to cover the unexpired risks on contracts of insurance entered into by the ECIC.

Note 2: The non-insurance reserve, equivalent to the ECIC's operating expenses for one year, was set up to safeguard against unusually poor underwriting results or investment performance.

Note 3: The fair value reserve was set up to reflect the unrealised appreciation in investments.

3.3 Under section 12(1)(d) and (e) of the ECIC Ordinance, the approval of the Financial Secretary (Note 4) is required for the policy pursued by the ECIC with respect to:

(a) the organisation of the finances of the ECIC and the determination of the use to which any surpluses acquired by the ECIC are to be put; and

(b) the determination of the total amount of the capital and reserves required by the ECIC taking into account the sums at risk under contracts of insurance entered into by the ECIC.

Use of the ECIC's surplus

3.4 In the Director of Audit's Report No. 18 of March 1992 (see para. 1.7), Audit recommended that the Government should:

(a) review the capital and reserve needs of the ECIC in the light of its business activities so that a formula agreeable to all the parties concerned could be drawn up for future use; and

(b) regularly monitor the operating results of the ECIC with a view to ascertaining whether any surplus had arisen, and if so, the optimum use of the surplus.

3.5 In 1995, in response to a Public Accounts Committee's recommendation (see para. 1.7), the Government completed a consultancy study on the financial needs, including the capital and reserve requirements, of the ECIC. In the light of the findings of the consultancy study, the ECIC was able to identify assets which were surplus to its requirements. In May 1996, the CEDB approved a plan for the usage of the ECIC's surplus. According to the plan, the surplus should be applied in the first instance to meet the ECIC's reserve requirements (see Table 4 in para. 3.2), and that the remaining surplus should be applied towards:

(a) the provision of practical support for the Hong Kong exporters, in the form of premium rate reduction and general improvements in services;

(b) the provision of new initiatives such as direct cover for bills discounting, tailor-made policies for various service industries, and the provision of medium-term cover for exports in both goods and services; and

(c) prudential investment either through the ECIC's fund managers or the ECIC itself.

Note 4: *The Financial Secretary's authority has been delegated to the Secretary for Commerce and Economic Development.*

Audit observations and recommendations

Reserve surplus to requirements

3.6 In February 2008, the ECIC commissioned a consultancy study to review the adequacy of its capital and reserves. The study, completed in October 2008, found that the total value of capital and reserves of $1,026.84 million held by the ECIC as at 31 March 2007 (see Table 4 in para. 3.2) was more than sufficient to meet the solvency requirements. The consultant recommended that the ECIC should discuss with the Government and seek its approval on how the surplus funds were to be utilised.

3.7 In August 2009, the ECIC commissioned another consultancy study to review the method of determining the required amount of contingency reserve which had been adopted since 1995-96. According to its report of November 2009, the consultant found that there had been structural changes in the ECIC's business and the existing method was no longer appropriate to fairly determine the amount of contingency reserve. The consultant proposed a new method for determining the required amount of contingency reserve. In December 2010, the CEDB approved the ECIC's proposal to adopt the new method. According to the ECIC's calculation using the new method, the required contingency reserve as at 31 March 2010 would be reduced and the surplus increased by a considerable amount. Audit considers that there is a need for the CEDB, in consultation with the ECIC, to review the plan (see para. 3.5) on how best the surplus should be put into optimum use.

Refund of the Government's capital injections

3.8 In 1966, when moving the Bill for the establishment of the ECIC, the Financial Secretary informed LegCo that the ECIC should run an insurance business for the benefit of commerce on a no-profit, no-loss basis. The Financial Secretary said that when the ECIC had built up its own sufficient reserves, it should refund its original capital to the Government and become fully self-supporting.

3.9 In 1999, the CEDB sought the ECIC's views on the refund of the Government's capital injections in relation to the ECIC's consideration on the use of surplus assets. In response, the ECIC considered that it was inadvisable for the Government to claw back the capital injections. The ECIC informed the CEDB that an adequate reserve was needed to boost exporters' confidence and for it to pursue a more proactive policy in supporting exporters by delivering more quality service and providing a fuller range of insurance cover. The CEDB agreed with the ECIC's views, but considered that the ECIC should revisit the issue in 2003-04.

3.10 In February 2002, the CEDB asked the ECIC to revisit the issue. In response to Audit enquiry, the CEDB informed Audit in February 2011 that:

(a) due to changed circumstances in the market over the years, the parameters of the review had not been finalised until December 2010; and

(b) the ECIC would revisit the issue of whether it could pay back the capital injections in 2011-12 after the completion of its financial audit for 2010-11.

3.11 Audit noted that as at 31 March 2010, the Government's capital injections of $20 million only represented 1.6% of the ECIC's total capital and reserves which amounted to $1,256.77 million (see Table 4 in para. 3.2). The impact of the refund on the ECIC's operations or creditworthiness is minimal. There is a need for the CEDB and the ECIC to revisit the issue in a timely manner because of:

(a) the Financial Secretary's statement to LegCo that the ECIC should refund its original capital to the Government and become fully self-supporting when it had built up its own sufficient reserves; and

(b) the time elapsed since 1996 when the ECIC had actually built up its own sufficient reserves (see para. 3.5).

Audit recommendations

3.12 **Audit has *recommended* that the Secretary for Commerce and Economic Development should, in consultation with the Commissioner, ECIC:**

(a) **review the plan on how best the surplus of the ECIC should be put into optimum use, including the use of the surplus to improve the ECIC's services provided to exporters; and**

(b) **revisit in a timely manner the issue of refunding the Government's capital injections of $20 million.**

Response from the Administration

3.13 The **Secretary for Commerce and Economic Development** agrees with the audit recommendations. She has said that:

(a) from time to time, the ECIC discussed with the Government regarding the use of surplus or the refund of capital. Over the years, the ECIC considers that the maintenance of adequate surplus will boost the confidence of exporters and enable it to pursue a more proactive policy in supporting exporters by delivering more quality service and providing a full range of insurance cover. The 2008 consultancy report assessed that the total value of capital and reserves held by the ECIC as at 31 March 2007 was more than sufficient to meet the solvency requirements (see para. 3.6). The ECIC reviewed the report in October 2008 and considered that in view of the deteriorating global economy and the rising trend in claims, the case should be further reviewed. Subsequently in August 2009, as recommended by the ECIC's external auditor, the ECIC commissioned a consultancy study on its contingency reserve (see para. 3.7). The study recommended a new contingency reserve calculation, which the CEDB approved in December 2010. In view of the latest development, the ECIC will discuss with the CEDB in 2011 the optimum use of the ECIC's surplus; and

(b) since February 2002, the CEDB has asked the ECIC to review the issue of refunding the Government's capital injections into the ECIC. Once the result of the review is available, the CEDB will consider the issue with other concerned government bureaux and departments.

PART 4: EXPORT CREDIT INSURANCE

4.1 This PART examines the following issues relating to provision of export credit insurance:

(a) policy underwriting (paras. 4.2 to 4.14);

(b) credit limit management (paras. 4.15 to 4.27);

(c) insurance claims (paras. 4.28 to 4.37);

(d) recoveries (paras. 4.38 to 4.46);

(e) reinsurance (paras. 4.47 to 4.53); and

(f) scope of insurance services (paras. 4.54 to 4.59).

A flowchart of the ECIC's export credit insurance operation is shown at Appendix B.

Policy underwriting

4.2 The term "policy underwriting" covers the activities in determining:

(a) the acceptability or otherwise of an export business for the purpose of providing an insurance cover; and

(b) the premium rate, premium loading, and basic terms and conditions of the insurance cover.

4.3 An exporter is required to complete a proposal form to apply for an insurance cover. In the proposal, the proposer provides information such as the business registration number, buyer profile and export turnover to be covered. The proposal should:

(a) contain true and correct answers that have a bearing on the risks to be covered; and

(b) include a declaration by the proposer by which he accepts that the proposal would form the basis of the eventual contract of insurance.

4.4 The ECIC uses a rule-based decision support system to review the proposal and check whether the information provided is adequate. It will issue a quotation if the proposal conforms to the ECIC's requirements. The quotation is an offer by the ECIC for cover against the proposal. On acceptance of the quotation, and payment of a policy deposit and a policy fee, the policy will be issued to the policyholder.

4.5 For the risks it assumes the ECIC receives premium. The ECIC's premium system consists of a premium matrix of basic rates (Note 5), and a scale of loadings (Note 6) to take account of variations of risk. According to the ECIC, the quality and spread of risks vary significantly from one policy to another. Therefore, the basic rates have to be adjusted by applying a premium loading to reflect the volume of insurable business and other factors such as the quality of the buyers, and the credit controls of the exporters. ECIC staff are required to give a rating on the factors for the assessment of the premium loading.

Audit observations and recommendations

Acceptance of quotation

4.6 According to the ECIC's guidelines, a quotation is valid for 14 days after issue. The validity period may be extended. Audit examined 10 quotations issued during the period April 2009 to October 2010 which were accepted by the prospective policyholders 60 days or more after the validity period. For 8 of the 10 quotations, documentation was not available showing the justifications for agreeing to the policyholders' acceptance after expiry of the validity period (see Table 5).

Note 5: *The rates in the premium matrix vary according to the durations of the credit period and the grading of the overseas markets.*

Note 6: *A loading is an increment expressed in percentage points over the basic rates in the premium matrix.*

Table 5

Quotations accepted without documentation of justifications

Quotation	End of validity period (a)	Quotation acceptance date (b)	No. of days after expiry of validity period (c) = (b) − (a)
1	2.10.2009	3.12.2009	62
2	23.12.2009	1.3.2010	68
3	11.1.2010	12.3.2010	60
4	13.1.2010	24.3.2010	70
5	19.2.2010	19.5.2010	89
6	7.5.2010	23.7.2010	77
7	19.5.2010	27.7.2010	69
8	28.7.2010	13.10.2010	77

Source: Audit analysis of ECIC records

Policy commencement date

4.7 According to the ECIC's guidelines, if a quotation is issued before the 15th of a calendar month, at the request of the prospective policyholder, the policy may commence on the first day of the same month provided that it is not earlier than the date of the proposal.

4.8 Audit examined 10 policies which commenced on the first day of a calendar month during the period April 2009 to November 2010. Audit noted that the quotations were issued before the 15th of the same month. However, the commencement date of one policy was a week earlier than the date of the proposal.

Determination of insurable business

4.9 The prospective policyholder is required to state in the proposal the estimated amount of turnover in credit terms (i.e. the volume of insurable business) per year. This amount will be used for determining the premium loading. The estimated amount of turnover in the proposal is sometimes adjusted after an assessment is made by ECIC staff. According to the ECIC's guidelines, ECIC staff should clarify with the prospective policyholder before making the adjustment.

4.10 Audit examined 30 proposals which were received during the period April 2009 to October 2010. Audit noted that for 11 proposals, the estimated amounts of the turnover were adjusted downwards by 33% to 78%. In 5 of the 11 proposals, no documentation was available to show that clarification with the prospective policyholders was made before the adjustment.

Assessment to determine premium loading

4.11 Audit noted that, up to December 2010, no guidelines had been issued on the assessment of the factors (see para. 4.5) for determining the premium loading for new policies or policy renewals. In response to Audit enquiry, the ECIC promulgated a set of guidelines for implementation with effect from 1 January 2011.

4.12 Audit reviewed the assessments for 20 policies (10 new and 10 renewed policies) which commenced during the period April 2009 to October 2010. Audit noted that there was no documentation of the justifications for the ratings given to the factors considered in making the assessments. To facilitate management review of the assessments made in determining the premium loading, Audit considers that the ECIC needs to ensure that proper documentation is kept to support the assessments.

Audit recommendations

4.13 **Audit has *recommended* that the Commissioner, ECIC should ensure that:**

(a) **quotations are accepted by prospective policyholders within the validity period. For cases involving acceptance of quotations after the validity period, proper documentation of the justifications should be kept;**

(b) **the policy commencement date is determined in accordance with the guidelines to properly reflect the ECIC's risk exposure;**

(c) **ECIC staff clarify with the prospective policyholders and document the results before making adjustments to the information provided in their proposals;**

(d) **the guidelines on the assessment of the factors for determining the premium loading for new policy or policy renewal are followed by ECIC staff; and**

(e) **proper documentation is always kept to support the assessment to determine the premium loading.**

Response from the ECIC

4.14 The **Commissioner, ECIC** agrees with the audit recommendations. He has said that:

(a) the ECIC will revise the existing work manual, update the computer system and remind its staff of the revisions and updates;

(b) the ECIC has enhanced the existing policy processing system to ensure that the policy commencement date is not earlier than the date of the proposal; and

(c) the ECIC plans to further enhance the policy processing system by 2011 to strengthen monitoring and control to ensure that the various guidelines are followed and proper documentation is kept by its staff.

Credit limit management

4.15 Upon receipt of a credit limit application (CLA) from a policyholder, a staff of the Underwriting Divisions assesses the credit limit that should be issued for the buyer of the policyholder. The credit limit is the maximum amount of loss covered in relation to that buyer. It has the effect of limiting the ECIC's liability to indemnify the policyholder for losses up to a certain value.

Audit observations and recommendations

Processing of CLAs

4.16 During the period November 2009 to October 2010, 32,893 CLAs were received. Audit reviewed the ECIC's management reports for the same period and found that, at the end of each month, there were on average 944 outstanding CLAs, 61 of which had been outstanding for more than 30 days (see Table 6). According to the ECIC, the long outstanding cases were caused by various reasons, such as awaiting credit reports from the credit agencies, awaiting responses from the policyholders on additional information required as well as delay in actions by ECIC staff.

Table 6

Average numbers of long outstanding CLAs as at month end (November 2009 to October 2010)

Outstanding period	No. of CLAs
31 to 50 days	43
51 to 70 days	15
71 to 97 days	3
Total	**61**

Source: Audit analysis of ECIC records

4.17 Audit reviewed 10 CLAs which had been outstanding for more than 30 days and noted that in 7 CLAs, there were delays in the actions taken by ECIC staff to obtain the required information. An example is given in Case 1.

Case 1

1. On 7 September 2010, the ECIC received a credit report on a buyer from a credit agency but the name and address of the buyer stated in the report were different from those in the CLA.

2. On 22 September 2010, the ECIC requested the policyholder to provide supplementary information on the buyer. The policyholder provided the information on 24 September 2010. However, the ECIC took one month's time to relay the information to the credit agency on 25 October 2010.

3. A clarification report was received from the credit agency on 9 November 2010 and the CLA was approved.

Audit comments

4. Audit considers that had more speedy actions been taken by the ECIC, the processing time might have been shortened.

Source: Audit analysis of ECIC records

Process review of CLAs

4.18 The ECIC carries out monthly reviews of the processing of CLAs. The purpose of the reviews is to check whether the CLAs have been processed according to the ECIC's operating procedures and whether the major risk factors (e.g. the buyers' background and financial strength) have been considered in the credit assessment.

4.19 The ECIC had three Underwriting Divisions. However, the process reviews were carried out by the same Division which approved the CLAs. There was no cross-checking among the three Divisions. Audit examination of the process reviews of 198 CLAs approved during the period August to October 2010 also revealed that:

(a) in 16 CLAs, the reviews were performed by the staff who approved the applications; and

(b) in 25 CLAs, the applications were approved by the senior management but the reviews were carried out by staff of a lower rank.

Risk rating of buyers

4.20 In November 2009, the ECIC introduced a new risk monitoring system. Under the system, buyers are classified into five categories according to their risk levels rated by the ECIC and buyers of higher risks are subject to more frequent reviews.

4.21 Up to 30 September 2010, 70% of the active buyers had been rated by the ECIC under the new system. Audit noted that there was no documentation to show how the assessments were made. In response to Audit enquiry, the ECIC imposed a new requirement with effect from 9 December 2010 that ECIC staff had to keep working papers to support their assessments.

Review of buyer risk

4.22 Regular and close monitoring of credit limits is important because it helps avoid over-exposure and ensure a good portfolio of credit risks. In the ECIC, buyer reviews covering the buyers' creditworthiness and utilisation of credit limits are conducted periodically according to a time schedule. Upon completion of the reviews, the ECIC would decide whether the credit limits need to be revised. If there is adverse information on the buyers, the staff will document the mitigation actions that are taken/to be taken to contain the risk to an acceptable level. However, if the staff decide not to adjust the credit limits, they are not required to document the decisions, including justifications.

Credit information

4.23 According to the ECIC's procurement guidelines:

(a) open tendering is required for any single purchase of goods or services exceeding a value of $1 million that can be provided by a large number of suppliers/service providers; and

(b) if open tendering is not carried out, the case should be justified, properly documented and approved.

4.24 The ECIC has engaged 47 credit agencies in various countries for providing credit reports on buyers. A credit agency for provision of credit information service has been engaged since 1981. Audit noted that under the 2010-11 subscription agreement with the agency (which was endorsed by the ECIC's Finance Committee chaired by the Commissioner), the ECIC subscribed credit reports at a cost exceeding $1 million. Open tendering was not carried out for renewal of the agreement with the agency in April 2010, but there was no evidence showing that approval for not adopting open tendering was obtained. In response to Audit enquiry, the ECIC informed Audit in February 2011 that unlike goods or services of a general nature that could easily be found and compared, credit information services provided by different credit agencies were rather different in terms of report content/cost/response time. Choices for comparison were limited and sometimes even not available. Credit information service was unique in nature and open tendering was not feasible.

4.25 As a good procurement practice, Audit considers that any deviation from the procurement guidelines should be justified, properly documented and approved.

Audit recommendations

4.26 **Audit has *recommended* that the Commissioner, ECIC should:**

(a) **ensure that ECIC staff process CLAs in a timely manner;**

(b) **ensure that process reviews of CLAs are carried out independently by staff at the appropriate level;**

(c) **ensure that ECIC staff keep proper documentation for buyer reviews, including the justifications for not adjusting the credit limits; and**

(d) **comply with the procurement guidelines to carry out open tendering for contracts with value exceeding $1 million. If no open tendering is carried out, the case should be justified, properly documented and approved.**

Response from the ECIC

4.27 The **Commissioner, ECIC** agrees with the audit recommendations. He has said that besides revising the existing work manual and updating the computer system, the ECIC will remind its staff of the updates. He has also said that:

(a) currently, there are daily statistics on the number of outstanding CLAs and monthly reports on long outstanding CLAs for monitoring by Heads of the Underwriting Divisions. The ECIC plans to introduce by 2011 additional measures (e.g. an improved alert system for routing long outstanding cases to Division Heads) to ensure handling of CLAs in a timely manner;

(b) to enhance the independence of the CLA reviews:

  (i) the ECIC has introduced cross-divisional checking with effect from January 2011; and

  (ii) the ECIC will change the basis of sample selection with effect from April 2011 to prevent the situations where cases approved by senior management are reviewed by staff at a lower rank;

(c) to ensure that proper documentation is kept for buyer reviews, ECIC staff are required to record the review results with effect from 28 December 2010. The ECIC plans to further enhance its buyer review system by 2011 to ensure that the review results, including the justifications for adjusting/not adjusting the credit limit commitments and actions required, are documented; and

(d) the ECIC will observe the procurement procedures to ensure that justifications will be provided and written approval obtained if a tender exercise is not carried out. It will submit an annual report on the procurement of credit information services to the Advisory Board's Audit Committee for information.

Insurance claims

4.28 The ECIC is required to pay claims in accordance with the terms and conditions of the insurance policy. In 2009-10, the ECIC had 335 cases with claims payments made in the year. The total amount of claims payments was $139.5 million.

Audit observations and recommendations

4.29 Audit examined 30 cases with claims payments made during the period April 2009 to October 2010. Audit findings are reported in paragraphs 4.30 to 4.35.

Claims payment for dispute cases

4.30 According to the ECIC's insurance policy, if a buyer raises any dispute on his obligation to pay, the ECIC will not pay claims until a final judgement enforceable against the buyer in the buyer's country has been obtained or that such dispute has been resolved in other manner approved by the ECIC. According to the ECIC's guidelines, the ECIC will consider evidence to assess whether the dismissal of the buyer's claims is justified. If a case is well justified, approval from senior management will be sought before making claims payment.

4.31 Audit examination of the 30 cases (see para. 4.29) revealed that 11 cases involved dispute. For four dispute cases, although the ECIC informed Audit that the claims payment decisions were made based on the merits of the cases, Audit noted that the approval from senior management was not obtained before the claims were paid.

Reporting of overdue payments by policyholders

4.32 Under the terms and conditions of the ECIC's insurance policy, a policyholder has to notify the ECIC immediately when he becomes aware of the occurrence of any event likely to cause loss, and to report the amounts which remain unpaid for more than two months from the due date for payment. Of the 30 cases examined, Audit noted that in 15 cases, the policyholders were late in reporting overdue payments. The delays ranged from 10 to 243 days (see Table 7).

Table 7

Delays in reporting overdue payments

Period of delay	No. of cases
10 to 20 days	2
21 to 30 days	5
31 to 40 days	3
41 to 70 days	3
71 to 200 days	0
Over 200 days (Note)	2
Total	**15**

Source: Audit analysis of ECIC records

Note: The longest delay was 243 days.

4.33 Late reporting of overdue payments would affect the chance of taking successful recovery actions against the buyers. Audit examination of the claims payments to the policyholders of these 15 cases revealed that claims payments were made to 3 policyholders despite that they had repeatedly been late in reporting overdue payments. An example is given in Case 2.

Case 2

1. A policyholder was late in reporting overdue payments for 60 days. The ECIC paid claims of $0.2 million to the policyholder in January 2010.

2. A further examination revealed that from November 2009 to March 2010, the policyholder had three other claims cases involving late reporting of overdue payments. The delays ranged from 26 to 87 days. The ECIC paid a total of $1 million for these three claims.

Audit comments

3. The prospect of obtaining payments from buyers dwindles with the passage of time. The late reporting of overdue payments may prevent the ECIC from taking prompt follow-up actions. Audit considers that the ECIC needs to remind policyholders of the requirement to report overdue payments in a timely manner. The ECIC also needs to ascertain whether there are repeated breaches of the policy's terms and conditions by the same policyholders before making claims payments.

Source: Audit analysis of ECIC records

In February 2011, the ECIC informed Audit that the claims payment decisions were made based on the merits of the cases and Case 2 was quite exceptional.

Omission of declarations

4.34 Omission of declarations refers to the failure of a policyholder to declare any of his insurable transactions to the ECIC. According to the ECIC's guidelines, omission means loss of premium income and can be a serious breach of the policy's terms and conditions. Once omission is accepted, the ECIC will remind the policyholder of the policy's terms and conditions and require him to declare the omitted shipments. The case will be monitored to check if the omitted shipments have subsequently been declared. Should the omission be rejected, the policyholder will be informed that the ECIC will not assume liability on the omitted shipments.

4.35 Audit examination of the 30 cases (see para. 4.29) showed that 12 cases involved omissions of declarations. Audit noted that the ECIC accepted the omissions for 8 cases and required the policyholders to declare the omitted shipments. In 3 of the 8 cases for which the claims were paid during the period April 2009 to January 2010, the omitted shipments were not yet declared up to October 2010.

Audit recommendations

4.36 **Audit has *recommended* that the Commissioner, ECIC should:**

(a) **ensure that the guidelines for obtaining prior approval are followed before making any claims payments for dispute cases;**

(b) **take measures to ensure that policyholders report overdue payments according to the terms and conditions of the insurance policy (e.g. by rejecting their claims);**

(c) **ascertain whether there are repeated breaches of the policy's terms and conditions by the same policyholders before making claims payments;**

(d) **take measures to ensure that policyholders declare all insurable transactions in a timely manner; and**

(e) **ensure that omitted shipments are subsequently declared (e.g. by withholding claims payments until the omitted shipments have been declared).**

Response from the ECIC

4.37 The **Commissioner, ECIC** agrees with the audit recommendations. He has said that:

(a) all claims payments have to be reviewed by the Head of the Claims Unit or the relevant Deputy General Manager before they are approved;

(b) the ECIC has identified some discrepancies in its guidelines and manuals for handling dispute cases. It will revise the guidelines and manuals in 2011;

(c) the ECIC will reinforce the current practice to remind policyholders of the requirement of reporting overdue payments in a timely manner;

(d) for cases where there is a breach of the terms and conditions of the policy, it is an established practice of the ECIC to issue a warning letter to the policyholders. The ECIC will consider enhancing its system in 2011-12 to identify policyholders who breach the terms and conditions repeatedly;

(e) on various occasions, the ECIC reminds policyholders of the requirement to declare insurable transactions. It will conduct a study in 2011 to strengthen the reminder system; and

(f) the omitted shipments of the three cases mentioned in paragraph 4.35 were subsequently declared in January 2011 and the premiums were settled. The ECIC has implemented new measures since January 2011 that claims payments will be withheld until omitted shipments have been declared.

Recoveries

4.38 As at 31 October 2010, there were 905 outstanding recovery cases, for which total claims payment of $516 million had been made. The total outstanding amount of these cases was $470 million (see Table 8).

Table 8

Outstanding recovery cases
(31 October 2010)

Outstanding period	No. of cases	Amount ($ million)
≤ 2 years	419 (46%)	185 (39%)
> 2 years to 4 years	172 (19%)	77 (16%)
> 4 years to 6 years	99 (11%)	42 (9%)
> 6 years to 8 years	69 (8%)	30 (6%)
> 8 years to 10 years	76 (8%)	78 (17%)
> 10 years to 12 years	47 (5%)	37 (8%)
> 12 years to 14 years	17 (2%)	17 (4%)
> 14 years to 18 years	6 (1%)	4 (1%)
Total	**905 (100%)**	**470 (100%)**

Source: Audit analysis of ECIC records

Audit observations and recommendations

4.39 Audit examined 20 of the 905 outstanding recovery cases. Audit findings are reported in paragraphs 4.40 to 4.44.

Review of outstanding recovery cases

4.40 According to the ECIC's guidelines, all outstanding recovery cases should be reviewed by the end of March every year to ascertain the progress and prospect of the recovery. In January 2011, the ECIC informed Audit that the cases were reviewed by ECIC staff in March every year in determining the estimated amount of recoveries before the year end and assessing the estimated amount of recoveries for the coming year. However, no documentation was available showing that reviews had been carried out to ascertain the recovery progress and prospect for each outstanding recovery case.

Follow-up action on outstanding recovery cases

4.41 According to the ECIC's guidelines, default/repudiation cases should be followed up every six months. Of the 20 outstanding recovery cases examined by Audit, 12 were classified by the ECIC as default/repudiation cases. For 8 of these 12 cases, there was no documentation indicating that they had been followed up every six months. An example is given in Case 3.

Case 3

1. In January 1999, the ECIC paid $3.7 million to a policyholder for a claims case.

2. In June 2001, the first debt-collector closed the case as the amount was not recoverable from the buyer.

3. In June 2002, the second debt-collector informed the ECIC that he had suggested the policyholder to file a lawsuit against the buyer.

4. In November 2004, the first debt-collector informed the ECIC that the prospect of recovery from the buyer was gloomy.

5. The ECIC did not take any follow-up action until October 2009. In November 2009, the second debt-collector informed the ECIC that the deadline of filing a lawsuit against the buyer was August 2004.

Audit comments

6. Had the ECIC followed up the progress of the case every six months in accordance with its guidelines, the deadline of filing the lawsuit might not have been missed. Audit considers that the ECIC needs to regularly follow up all outstanding recovery cases and closely monitor any time limits for taking recovery actions.

Source: Audit analysis of ECIC records

Resale of distressed merchandise

4.42 Under the terms and conditions of the ECIC's insurance policy, if a buyer did not take delivery of the goods, the goods will be resold. All sums recovered are to be shared between the ECIC and the policyholder.

4.43 Of the 20 cases examined by Audit (see para. 4.39), 7 cases involved resale of distressed merchandise. In 2 of the 7 cases, the ECIC did not follow up on the resale of the distressed merchandise in a timely manner. An example is given in Case 4.

Case 4

1. In January 1999, the ECIC paid $4.5 million to a policyholder for a claims case.

2. In January 2000, the ECIC noted that the goods not taken up by the buyer were resold. Since January 2000, the ECIC had been liaising with the policyholder with a view to obtaining details about the resale proceeds. However, up to October 2010, the policyholder had not provided details of the resale proceeds to the ECIC.

Audit comments

3. Under the policy's terms and conditions, the policyholder must pay to the ECIC its share of the recoveries not later than one month after the receipt of such recoveries by the policyholder. Audit considers that the ECIC should have taken more vigorous action to follow up the case with the policyholder in order to obtain its share of the recoveries.

Source: Audit analysis of ECIC records

Write-off of recovery cases

4.44 According to the ECIC's guidelines, a case should be written off as soon as practicable where the prospect of recovery is non-existent or too remote. For 3 of the 20 cases examined, Audit noted that there was little chance of recovery. However, up to October 2010, they had not been written off. Details of the three different cases were as follows:

(a) in the first case, in September 2005, the debt-collector informed the ECIC that the case had been closed more than three years ago;

(b) in the second case, another claims case involving the same buyer was written off in March 2010 after the trustee of the buyer's estate informed the ECIC that there would not be any distribution from the buyer's estate; and

(c) in the third case, another claims case involving the same buyer was written off in March 2010 after the buyer's Scheme of Arrangement was approved and became binding between the buyer and all unsecured creditors. Under the Scheme, there would not be any additional distribution from the buyer.

Audit recommendations

4.45 **Audit has *recommended* that the Commissioner, ECIC should:**

(a) **regularly review all outstanding recovery cases according to the guidelines;**

(b) **take prompt follow-up actions in pursuing recoveries;**

(c) **closely follow up on the resale of distressed merchandise to avoid any possible loss in recoveries; and**

(d) **write off cases as soon as practicable where the prospect of recovery is non-existent or too remote.**

Response from the ECIC

4.46 The **Commissioner, ECIC** agrees with the audit recommendations. He has said that the ECIC:

(a) will continue to review regularly all outstanding recovery cases. The ECIC will further strengthen the recovery function by holding regular recovery review meetings. It will also enhance the computer system in 2011-12 to facilitate closer monitoring of the regular review progress by the Head of the Claims Unit;

(b) will take prompt follow-up actions in pursuing recoveries;

(c) will enhance the computer system in 2011-12 by highlighting distressed merchandise cases so that staff can take priority to handle them;

(d) has reviewed all the 910 recovery cases which were outstanding as at 31 January 2011. It has followed up with the policyholders or debt-collectors/liquidators at least once in the last 12 months if there was recovery prospect. The ECIC is taking follow-up action on 660 cases. The remaining 250 cases with no recovery prospect will be written off in the first half of 2011-12; and

(e) wrote off Case 3 (see para. 4.41) in February 2011 because it had no recovery prospect. For Case 4 (see para. 4.43), the ECIC is taking follow-up action. If the policyholder still fails to provide information on the resale proceeds, the ECIC will seek legal advice on the appropriate follow-up action.

Reinsurance

4.47 The ECIC reduces its risk exposure by taking out reinsurance cover through a "quota share" treaty with reinsurers. Under the treaty, all premiums, claims and recoveries relating to buyer risks are shared with reinsurers on a pre-agreed percentage.

Audit observations and recommendations

Review of ceding ratio

4.48 According to the ECIC's guidelines, the reinsurance treaties with reinsurers are reviewed annually to ensure that the best possible provisions and benefits are attained. Internal reviews on the provisions of the treaties and reinsurance arrangement should also be conducted to examine the optimum proportion of buyer risks to be retained by the ECIC, taking into account changes in:

(a) the business portfolio;

(b) the extent of risk exposure; and

(c) the availability of reinsurance capacity for medium or long-term cover.

4.49 In March 1995, the Advisory Board was informed that according to the ECIC's review on the optimum ceding ratio (i.e. the reinsurers' share) of the "quota share" treaty, it was sufficient and prudent for the ECIC to increase its own retention percentage under the treaty. Since that increase, the ECIC's retention percentage has remained unchanged. Audit examined the ECIC's records for the renewals of the 2006-07 to 2010-11 reinsurance treaties. Audit noted that no documentation was available showing that the ECIC had followed its guidelines and conducted detailed reviews of its optimum ceding ratio.

Reporting of major changes in reinsurance treaty to Advisory Board

4.50 In 2005, the ECIC considered the need for enhancing the reinsurance arrangement to expand its business capability for large covers. In 2006, the ECIC modified the "quota share" treaty with the reinsurers to vary the ceding ratio for large commitment to contain its maximum exposure. Although the ECIC had informed the CEDB of the modified "quota share" treaty, it had not informed the Advisory Board of the modification.

4.51 In addition to the "quota share" treaty, the ECIC took out "excess of loss" reinsurance for a number of years to obtain protection against individual major losses. In 2007, the ECIC decided to terminate the "excess of loss" treaty. Again, the ECIC had informed the CEDB but not the Advisory Board.

Audit recommendations

4.52 **Audit has *recommended* that the Commissioner, ECIC should ensure that:**

(a) **regular reviews of the optimum ceding ratio of reinsurance are conducted in accordance with the ECIC's guidelines, and the results are properly documented; and**

(b) **major changes relating to the reinsurance treaty with reinsurers are reported to the Advisory Board.**

Response from the ECIC

4.53 The **Commissioner, ECIC** agrees with the audit recommendations. He has said that:

(a) starting from 2011, the ECIC will document its analysis of the optimum ceding ratio of reinsurance treaty; and

(b) starting from 2011-12, the ECIC will inform the Advisory Board, in addition to the CEDB, of major terms of the reinsurance treaty annually.

Scope of insurance services

4.54 The mission of the ECIC is to support export trade. Section 9(3) of the ECIC Ordinance provides that the ECIC shall not enter into contracts of insurance against risks that are normally insured with commercial insurers.

Audit observations and recommendations

4.55 According to the ECIC, as of December 2010, there were seven commercial insurers which provided export credit insurance cover in Hong Kong. Audit noted that some of the exporters did not renew their policies with the ECIC because they had switched their covers to the commercial insurers.

4.56 In response to Audit enquiry regarding the implications of the restriction stipulated in section 9(3) of the ECIC Ordinance on its services, the ECIC informed Audit in December 2010 that:

(a) ***Commercial insurers' services might not be available to all exporters.*** Commercial insurers selected their customers based on the market situation and their business strategies (large exporters were preferred). Small and medium exporters might have difficulties in obtaining insurance cover from them. On the other hand, the ECIC provided insurance services to exporters regardless of their size. Moreover, the ECIC provided a wider standard insurance cover such as non-payment risk arising from the buyer's refusal to take delivery of goods and country risks, which were not normally offered by commercial insurers;

(b) ***The existence of the ECIC was important.*** Amid the global financial crisis in the second-half of 2008 and in 2009, commercial insurers reduced their cover drastically. However, the ECIC continued to extend the cover and recorded significant increases in its total exposure (see para. 1.8). The ECIC had not increased the premium rates across-the-board, while reportedly commercial insurers had made across-the-board increase of premium rates; and

(c) ***The current market condition affirmed the ECIC's role.*** On a monthly basis, the ECIC collected and reviewed market information and information of commercial insurers, including their products. The information collected affirmed the ECIC's position as the backbone provider of export credit insurance services in Hong Kong.

4.57 Audit reviewed the insurance services offered by the ECIC to the exporters. Audit found that:

(a) the ECIC had not promulgated any guidelines to its staff stipulating that before entering into an insurance contract, they should satisfy themselves that it was not a contract against risks that were normally insured with commercial insurers; and

(b) the ECIC did not carry out regular reviews of its services to ensure that its insurance contracts were not against risks that were normally insured with commercial insurers.

The ECIC needs to ensure that it operates in accordance with section 9(3) of the ECIC Ordinance.

Audit recommendations

4.58 **Audit has *recommended* that the Secretary for Commerce and Economic Development should:**

(a) **assess, including seeking legal advice, the implications of section 9(3) of the ECIC Ordinance on the services currently provided by the ECIC; and**

(b) **if necessary, take measures to rectify the situation to ensure that the scope of the ECIC's services complies with section 9(3) of the ECIC Ordinance.**

Response from the Administration

4.59 The **Secretary for Commerce and Economic Development** agrees with the audit recommendations. She has said that:

(a) the CEDB consulted the Commissioner of Insurance in 2007 and 2010 on whether the services provided by the ECIC were available from commercial insurers. The Commissioner of Insurance then advised the CEDB that non-payment risk arising from the buyer's refusal to take delivery of goods (i.e. repudiation risk) was not normally included in the standard cover provided by commercial insurers but might be provided on a case-by-case basis. It was well known in the market that the ECIC was a major provider for such kind of insurance cover. The CEDB also understands that commercial insurers do not normally provide insurance cover for country risks, which is a standard cover in the ECIC's insurance policy;

(b) the Commissioner of Insurance also advised the CEDB that credit insurance was a highly volatile business. The appetite and capacity of commercial insurers for risk-taking, as well as the demand of exporters were very much influenced by market sentiment and economic outlook. The availability of a particular insurance product in the market would therefore vary from time to time. Moreover, other overseas government or quasi-government agencies akin to the ECIC were set up with the purposes of supporting export trade and filling the gap of supply in the commercial market;

(c) the majority of policyholders of the ECIC are SMEs, which generate much smaller premium incomes but require relatively higher service costs. Over 85% of the ECIC's 3,800 policyholders have an average insured business (i.e. sales volume) of lower than $5 million. As stated in paragraph 4.56(b), during the recent global financial crisis, when commercial insurers reduced their cover drastically, the ECIC continued to extend its cover and recorded significant increases in its total exposure. As shown in Table 1 in paragraph 1.3, the insured business of the ECIC increased from $47,180 million in 2008-09 by $16,968 million (36%) to $64,148 million in 2009-10;

(d) while there are commercial insurers offering export credit insurance cover in Hong Kong, the details of each cover vary with each insurer. For example, country risks, repudiation risk and pre-shipment cover are not normally available from them. The ECIC does not aim to compete with the private market, but to fill the market gap where the capacity of the private commercial sector is limited or insufficient to support the needs of Hong Kong exporters, especially SMEs. It will, as far as practicable, only provide insurance services which are not commonly available in the market; and

(e) for the reasons mentioned in (a) to (d) above, the CEDB considers that the ECIC is providing services within the ambit of section 9(3) of the ECIC Ordinance. That said, the CEDB will seek legal advice on this issue to reconfirm that the services provided by the ECIC are in line with section 9(3) of the ECIC Ordinance and take action to rectify the situation if necessary.

PART 5: HUMAN RESOURCE MANAGEMENT

5.1 This PART examines issues relating to human resource management.

Staff turnover

5.2 High staff turnover usually causes significant disruption to the operation of an organisation. The organisation needs to incur additional expenditure in recruiting replacement staff to fill the vacancies arising from staff turnover.

Audit observations and recommendation

5.3 The staff turnover rate of the ECIC for 2007-08 to 2009-10 ranged from 14.2% to 21.8% (see Table 9).

Table 9

Staff turnover rate
(2007-08 to 2009-10)

Year	No. of staff left	Turnover rate
2007-08	17	17.5%
2008-09	15	14.2%
2009-10	24	21.8%

Source: ECIC records

5.4 The ECIC faced human resource pressure with high staff turnover in the last three years. The staff turnover rate of 14.2% in 2008-09 increased significantly to 21.8% in 2009-10. As at 31 October 2010, 43% of its staff had not more than three years of service with the ECIC. The high staff turnover had the following adverse impacts on the ECIC's operation:

(a) the ECIC had to incur a larger amount of expenditure and deploy staff resources in recruiting and training new staff; and

(b) the quality of the ECIC's services provided to its customers might have been affected because of the departure of experienced staff.

Audit recommendation

5.5 **Audit has *recommended* that the Commissioner, ECIC should investigate the reasons for the high staff turnover and devise measures to address the problem.**

Response from the ECIC

5.6 The **Commissioner, ECIC** agrees with the audit recommendation. He has said that:

(a) since October 2009, the ECIC has conducted exit interviews with all resigned staff. It will report to the Advisory Board in 2011 the findings of its interviews and recommend follow-up action where appropriate; and

(b) the ECIC regularly reviews its remuneration scheme to ensure that staff remuneration is in line with the market. In 2010-11, the ECIC engaged a consultant for this regular review. It will review the consultant's recommendations and seek advice from the Advisory Board and the CEDB for necessary actions to be taken in 2011-12 to address the high staff turnover problem.

Staff recruitment

5.7 Due to staff turnover and the creation of new posts (Note 7), the ECIC conducted staff recruitment exercises from time to time. According to the ECIC's "Handbook on Human Resource Management", staff recruitment and selection are founded on the core principles of fairness, equity and open competition on merit and ability, having regard to the specific requirements of the posts or jobs concerned.

Audit observations and recommendations

5.8 Audit examined the ECIC's records for 10 recruitment exercises which were conducted from 2008 to 2010. Audit found that there was room for improvement in conducting staff recruitment.

Note 7: *During the period April 2008 to November 2010, 23 new posts (comprising 7 permanent staff and 16 contract staff) were created.*

5.9 It is a good practice in staff recruitment to shortlist the applicants according to their qualifications and experience. Only the shortlisted candidates should be invited to attend selection tests and interviews. Audit noted that in December 2009, after the selection process, the Commissioner's approval was obtained to appoint a candidate for the post. However, before offering the appointment, it was discovered that the candidate did not possess the working experience which the ECIC considered preferable for the post. In other words, the candidate should not have been shortlisted and chosen. The Commissioner's approval was sought again for appointing another candidate. Audit considers that the ECIC needs to draw lessons from this case.

5.10 Audit also noted that shortlisting was carried out for all the 10 recruitment exercises examined. However, the shortlisting criteria (e.g. years of working experience) were not clearly set out and documented. In 9 of these 10 exercises, the rank and post of the staff responsible for preparing and approving the shortlist were also not documented.

Audit recommendations

5.11 **Audit has *recommended* that the Commissioner, ECIC should promulgate guidelines for shortlisting of candidates in staff recruitment exercises. In particular, the guidelines should specify that, in each recruitment exercise:**

(a) **the shortlisting criteria are clearly set out; and**

(b) **the rank and post of the staff responsible for preparing and approving the shortlist are properly documented.**

Response from the ECIC

5.12 The **Commissioner, ECIC** agrees with the audit recommendations. He has said that:

(a) the ECIC agrees that shortlisting criteria should be clearly set out. The ECIC has enhanced its screening process to prevent irregularity similar to the one mentioned in paragraph 5.9 from happening again; and

(b) since February 2011, the ECIC has started to document the rank and post of the staff responsible for the selection process.

New remuneration system

5.13 Before April 2008, the ECIC's staff remuneration system was linked to that of the civil service. Following a consultancy review of the ECIC's remuneration system in 2006, the CEDB approved the implementation of a new remuneration system with effect from 1 April 2008. Under the new system, the remuneration package of ECIC staff comprises a monthly basic salary targeting around the market average and an annual incentive pay subject to corporate and individual performance. In 2008-09 and 2009-10, incentive pays of some $674,000 and $852,000 respectively were given to ECIC staff.

Audit observations and recommendations

Payment of acting allowance

5.14 According to the ECIC's Handbook on Human Resource Management, an acting appointment may be made in respect of a temporary absence of a substantive holder to meet management or operational needs, or for the purpose of testing the performance of an officer to assess his suitability for substantive appointment to a higher post. A staff who is offered an acting appointment for 30 calendar days or more is eligible for an acting allowance. In 2008-09 and 2009-10, acting allowances of some $550,000 and $295,000 respectively were paid to ECIC staff.

5.15 The payment of acting allowance is similar to the arrangement in the civil service. As the ECIC's staff remuneration system was delinked from that of the civil service and benchmarked with the market with effect from 1 April 2008, the ECIC needs to ascertain whether the continued adoption of the acting allowance arrangement is in line with the market practice.

Use of the ECIC's car for home-to-office return journeys

5.16 The established practice in the ECIC is that the Commissioner is given free use of the ECIC's car for home-to-office return journeys. However, free use of the ECIC's car was not included in the Memorandum of Conditions of Service for the Commissioner, which was approved by the CEDB. In consultation with the CEDB, the ECIC needs to review the practice of giving the Commissioner the free use of the ECIC's car for home-to-office return journeys.

Audit recommendations

5.17 **Audit has *recommended* that the Commissioner, ECIC should, in consultation with the Secretary for Commerce and Economic Development:**

(a) **conduct a review of the payment of acting allowance, taking into account the market practice; and**

(b) **review the practice of giving the Commissioner the free use of the ECIC's car for home-to-office return journeys.**

Response from the ECIC

5.18 The **Commissioner, ECIC** agrees with the audit recommendations. He has said that:

(a) the ECIC will, taking into account the market practice, review the existing arrangement on the payment of acting allowance; and

(b) the consultancy report in 2006 (see para. 5.13) had reviewed the ECIC's practice to give the Commissioner free use of the ECIC's car for home-to-office return journeys. It commented that the practice was in line with that of the market. The free use of the ECIC's car by the Commissioner for home-to-office return journeys is stated in the ECIC's guidelines but not in the Commissioner's Memorandum of Conditions of Service. In February 2011, the ECIC submitted an application to the CEDB for inclusion of the Commissioner's free use of the ECIC's car for his home-to-office return journeys in the Memorandum.

Response from the Administration

5.19 The **Secretary for Commerce and Economic Development** has said that the ECIC's application mentioned in paragraph 5.18(b) was approved in March 2011.

PART 6: FINANCIAL AND ADMINISTRATIVE ISSUES

6.1 This PART examines financial and administrative issues.

Financial budget

6.2 Every year in March, the ECIC prepares a financial budget for the coming year. The budget is submitted to the Advisory Board for discussion and endorsement.

Audit observations and recommendations

Insufficient information in financial budget

6.3 The ECIC's budget only provides six items of expenditure, namely staff costs, economic and status information (Note 8), depreciation, marketing expenses, office management and professional fees. The expenditure items are not analysed in greater details to provide information on the components of the expenditure estimates (e.g. a breakdown of the staff costs into items such as salaries and other benefits including contribution to provident fund, incentive pays and allowances). Therefore, it is difficult for the Advisory Board to examine the budget to ensure that funds are used in an appropriate manner.

Approval for excess expenditure

6.4 In 2008-09 and 2009-10, the actual amounts for the following expenditure items exceeded the amounts in the financial budgets endorsed by the Advisory Board:

(a) ***2008-09.*** The actual expenditure of $11,967,891 for economic and status information exceeded the budgeted amount of $10,100,000 by $1,867,891 (18.5%). The actual expenditure of $5,666,497 for marketing expenses exceeded the budgeted amount of $4,550,000 by $1,116,497 (24.5%); and

(b) ***2009-10.*** The actual expenditure of $5,046,587 for office management slightly exceeded the budgeted amount of $5,000,000 by $46,587 (0.9%).

Note 8: *This expenditure item mainly relates to expenses incurred on subscribing credit reports on buyers from credit agencies (see para. 4.24).*

6.5 Audit noted that the ECIC did not seek the endorsement of the Advisory Board for the expenditures which exceeded the budgeted amounts. Instead, only the Commissioner’s approval was obtained. Audit considers that, as the original financial budgets were endorsed by the Advisory Board, the Board’s endorsement should also have been obtained for expenditures which exceeded the budgeted amounts.

Audit recommendations

6.6 **Audit has *recommended* that the Secretary for Commerce and Economic Development should require the ECIC to:**

(a) **provide the Advisory Board with more details of the components of the expenditure items included in the financial budget to facilitate its consideration and endorsement; and**

(b) **obtain the endorsement of the Advisory Board for expenditures which exceed the budgeted amounts.**

Response from the Administration

6.7 The **Secretary for Commerce and Economic Development** agrees with the audit recommendations. She has said that:

(a) the CEDB has asked the ECIC to provide the Advisory Board with more details of its expenditure in its financial budget and to obtain the endorsement of the Advisory Board for expenditures which exceed the budgeted amounts; and

(b) the ECIC will provide the Advisory Board with more details of the components of the expenditure items included in the budget from 2011 onwards and will obtain the necessary endorsement for expenditures which exceed the budgeted amounts.

Approval of duty trips outside Hong Kong

6.8 Duty trips outside Hong Kong undertaken by public officers incur public money and resources. They are sensitive expenditure and therefore should be fully justified. In July 2005, the Chief Executive gave a specific instruction to policy bureaux that each and every duty visit, requiring public funds or manpower resources, had to be:

(a) justified in terms of need, duration, etc. against the money and manpower resources required; and

(b) specifically approved by a proper authority. If a statutory organisation worked to a governing board, the duty trips of the head of that organisation should be approved by the chairman of the board.

The Chief Executive instructed that the heads of statutory organisations should be informed of the requirements.

Audit observations and recommendations

6.9 Audit noted that the CEDB had not relayed the Chief Executive's instruction to the ECIC. According to the ECIC's records:

(a) since September 2003, its former Commissioner had not sought the CEDB's approval or informed the CEDB of his duty visits outside Hong Kong; and

(b) during the period 1 January to 11 July 2008, the former Commissioner made 25 duty trips mainly to the Mainland.

6.10 To tighten the controls on duty visits, on 24 July 2008, the CEDB advised the ECIC that with immediate effect, the Commissioner (or Acting Commissioner) should seek the CEDB's approval and inform the Chairman of the Advisory Board in advance for all duty visits. Since then, the ECIC has followed the CEDB's advice accordingly.

Audit recommendations

6.11 **Audit has *recommended* that the Secretary for Commerce and Economic Development should ensure that:**

(a) **all measures to improve control over duty visits are relayed to the ECIC in a timely manner; and**

(b) **the control measures are strictly complied with.**

Response from the Administration

6.12 The **Secretary for Commerce and Economic Development** agrees with the audit recommendations. She has said that the CEDB will continue to ensure that the control measures introduced in July 2008 are strictly complied with by the ECIC.

Management of outsourcing contracts

6.13 At an Advisory Board meeting held in August 2008, the Board suggested the ECIC to consider whether it would be suitable to engage an external party to conduct a review of its internal control procedures. In January 2009, the ECIC engaged a consultant (Consultant 1) to conduct a review of areas including travelling and entertainment expenses, and tendering and disbursement of IT development and consultancy projects. Consultant 1 completed the review in May 2009. In June 2009, the ECIC informed the Advisory Board that it had accepted Consultant 1's recommendations and would take into account the Board's comments in implementing the recommendations to improve the internal control policies/procedures. In September 2009, the ECIC engaged another consultant (Consultant 2) to review the appropriateness of its actions taken, and to conduct an implementation review. In its review report, Consultant 2 concluded that the ECIC had satisfactorily implemented all the recommendations.

6.14 Consultant 1's review report described irregularities (Note 9) in some of the outsourcing contracts awarded to a company in the Mainland (**Company A**). In 2007-08, the ECIC awarded seven contracts (Contracts 1 to 7 — see Appendix C) to Company A. An outsourcing IT centre was established in the Mainland by the Company for delivery of the services. All the seven contracts were either completed or early terminated before October 2009. Total payment made to Company A amounted to $12.3 million (including $1 million for staff layoff and other payments not covered by the contracts).

Audit observations and recommendations

6.15 Audit reviewed the ECIC's management of the outsourcing contracts, focusing on the seven contracts awarded to Company A, with a view to ascertaining whether there was room for improvement in contract management. Audit findings are reported in paragraphs 6.16 to 6.29.

Weaknesses in the selection process

6.16 When the contracts were awarded to Company A during the period August 2007 to January 2008, the ECIC did not have any laid-down procurement policy or procedures on the procurement of goods and services. Before selecting Company A, the ECIC only carried out a vendor evaluation on three service providers. No tendering exercise was conducted.

Note 9: *Such irregularities included:*

(a) insufficient justification was provided for selecting Company A as the service provider;

(b) the contract terms were prepared with too much flexibility which led to certain clauses and terms left open for negotiation on a case-by-case basis; and

(c) the ECIC made payments to the personal bank account of one of Company A's shareholders.

6.17 Audit noted that Company A was newly set up by a staff of the ECIC's previous contractor whose contract was early terminated in July 2007 because of unsatisfactory performance. The previous contractor had 15 staff. Of the 17 staff of Company A providing services to the ECIC, 14 were former staff of the previous contractor. Had the ECIC taken into account this background of Company A, it would have cast doubt on the Company's ability to deliver satisfactory services to the ECIC.

Evaluation of Company A's ability

6.18 The ECIC did not assess the ability of Company A before awarding the seven contracts to it. In August 2007, after Contract 1 was awarded to the Company, the ECIC appointed a person (Person A) in the Mainland at a fee of $15,000 to assess the manpower and technical knowledge of Company A's staff in developing the pilot design of the new IT systems in Contract 1. Person A assessed the technical skill and professional ethics of only two of Company A's staff and concluded that they had the ability to perform the duties in their current job positions. Based on Person A's assessment report, the ECIC considered that Company A possessed adequate manpower and technical knowledge to develop the IT systems in Contract 1 for the ECIC.

6.19 The evaluation of Company A's ability after award of Contract 1 was unsatisfactory because:

(a) before awarding the Contract, the ECIC had not obtained all the required information to ensure that Company A was capable of delivering reliable services;

(b) as Person A had only assessed the ability of two of Company A's staff, there was insufficient evidence to conclude that Company A had the ability to develop the IT systems; and

(c) the ECIC's appointment of Person A was based on a referral by Company A. The ECIC's communications with Person A were all channelled through Company A. The independence of Person A and the reliability of his assessment report were therefore highly doubtful.

Irregularities in the award of Contract 2

6.20 In his assessment report of September 2007, Person A recommended the ECIC to conduct a further study on the design planning of the IT systems. Based on this recommendation, the ECIC awarded Contract 2 to Company A for the provision of consultancy service for developing the IT systems. The contract covered a six-month period at a monthly charge of $40,000.

6.21 Audit noted that:

(a) the decision to award Contract 2 to Company A was made on 25 October 2007 and the contract was signed with Company A on 31 October 2007. However, the contract commencement date was backdated to 1 October 2007. Although no service was rendered by Company A for the month of October 2007, the ECIC started making the monthly contract payments of $40,000 with effect from 1 October 2007;

(b) Person A was subsequently employed by Company A for providing the consultancy service under Contract 2. It appeared that he had created the consultancy contract for himself and there was a serious conflict of interest in this case; and

(c) the payments of all contract charges were not supported by proper invoices from Company A. Upon Company A's requests, the ECIC made the contract payments to the Company through a personal bank account in Hong Kong of one of Company A's shareholders (see Note 9(c) to para. 6.14).

Inadequacies in preparing contracts

6.22 In its examination of Contracts 3, 4 and 5, Consultant 1 commented that the contract terms were not prepared at an appropriate level of detail. Certain clauses and terms were left open for negotiation on a case-by-case basis which exposed the ECIC to unnecessary risk.

6.23 The ECIC had not arranged for the contracts to be legally vetted before they were signed. Audit noted that the contracts did **not** include:

(a) the standard elements specifying the scope of work, key deliverables/products, key project milestones/delivery schedule, and acceptance standards and procedures of the deliverables/products (except Contract 7);

(b) the conditions and arrangements for withholding/reducing contract payments in cases of unsatisfactory performance; and

(c) the indemnity arrangements for early termination of contracts.

Difficulties in monitoring contract performance

6.24 As the contracts did not specify the key deliverables/products and key project milestones/delivery schedule, there might be expectation gaps between the ECIC and Company A on the service requirements. It would be difficult for the ECIC to monitor the performance of Company A and its staff in delivering the contract services. Because payments for six of the seven contracts were on a "time charge" instead of a "lump sum" basis, there was a higher risk that Company A might prolong the project completion time in order to obtain more contract payments. In this connection, the ECIC might have paid Company A extra fees for its staff to work overtime in order to fix programming bugs and to complete the work which was behind schedule. Furthermore, the ECIC only relied on a monthly schedule of staff attendance provided by Company A as the basis to support payment of the monthly contract charges. There was no documentation available showing that the ECIC had verified the accuracy of the schedule. Audit noted that the ECIC had also paid some $40,000 for the layoff expenses for a staff of Company A even though the staff was dismissed due to poor performance.

Salary of outsourced staff

6.25 The outsourced staff were given salary increases just a few months after the commencement of the contracts and the agreed monthly salary per individual staff kept changing (see Appendix D). The salary increases were borne by the ECIC. Audit noted that the salary increases were made by the ECIC according to its evaluation of individual staff's performance. However, such salary increases were only supported by internal file notes and no change requests/contract addendums had been signed between the ECIC and Company A.

6.26 Audit reviewed the justifications for awarding the salary increases to the outsourced staff. Audit noted that at a senior management meeting held in September 2007, the ECIC found that Company A had critical management problems in providing the outsourcing services under Contract 1. At the meeting, the ECIC senior management agreed that the ECIC might consider terminating the contract with Company A if its performance showed no improvement. Notwithstanding this, at the same meeting, it was reported that five outsourced staff (Staff 1 to Staff 5 at Appendix D) performed well under the contract. The ECIC decided to increase their salaries by 9.5% to 66.7% with effect from 1 October 2007. One of the five staff (Staff 2) was given a further salary increase of 12.9% from 1 November 2007.

6.27 Since the ECIC considered that the quality of services provided by Company A under Contract 1 was unsatisfactory, it was not logical to have increased the contract payments to Company A by increasing the salaries of the outsourced staff. Given that there was no documentation on the performance evaluation of the five staff, the salary increases, which were given only two months after the commencement of the contract, appeared unjustifiable.

Inadequacies in contract planning

6.28 Audit noted that 4 of the 7 contracts were terminated before their expiry dates (ranging from 10 to 31 months — see Appendix C) due to various reasons, such as the workload or the IT services for outsourcing had been reduced.

6.29 The early termination of the four contracts (Contracts 3 to 6) reflected that there were weaknesses in contract planning. As the contracts had no provision for indemnity arrangements for early termination and staff layoffs, a total amount of $0.56 million was paid for staff layoffs after negotiations with Company A.

Audit recommendations

6.30 **Audit has *recommended* that the Commissioner, ECIC should ensure that:**

(a) **contracts are awarded through tendering exercises instead of selecting contractors simply based on vendor evaluations;**

(b) **all factors that may affect the service quality of the contractors are taken into account in assessing their ability to provide the contract services;**

(c) **if a third party's advice on the service quality or ability of the service providers is required, he should be an independent person and there should not be any conflicts of interest;**

(d) **contract commencement date is set in accordance with the date of contract signing and should not be backdated;**

(e) **contracts are prepared with sufficient details and are properly vetted by legal professionals. In particular, standard elements (covering the scope of work, key deliverables, key project milestones and remedies for unsatisfactory contract performance, etc.) should be clearly specified in the contract documents;**

(f) **contract payments are made based on services actually provided by the contractors and received by the ECIC;**

(g) **any changes to the terms and conditions of the contracts, such as contract payments, are fully justified and are properly supported by contract addendums; and**

(h) **service requirements are properly assessed before outsourcing contracts are awarded to avoid premature contract terminations.**

Response from the ECIC

6.31 The **Commissioner, ECIC** agrees with the audit recommendations. He has said that the ECIC, in consultation with the Advisory Board and the CEDB, has taken steps to strengthen its internal control procedures since 2008. The ECIC has also tightened up its internal guidelines. He has also said that:

(a) a new work manual on procurement and contract management was issued on 2 October 2008 to ensure that procurement and contract management would be conducted and documented properly in a consistent manner;

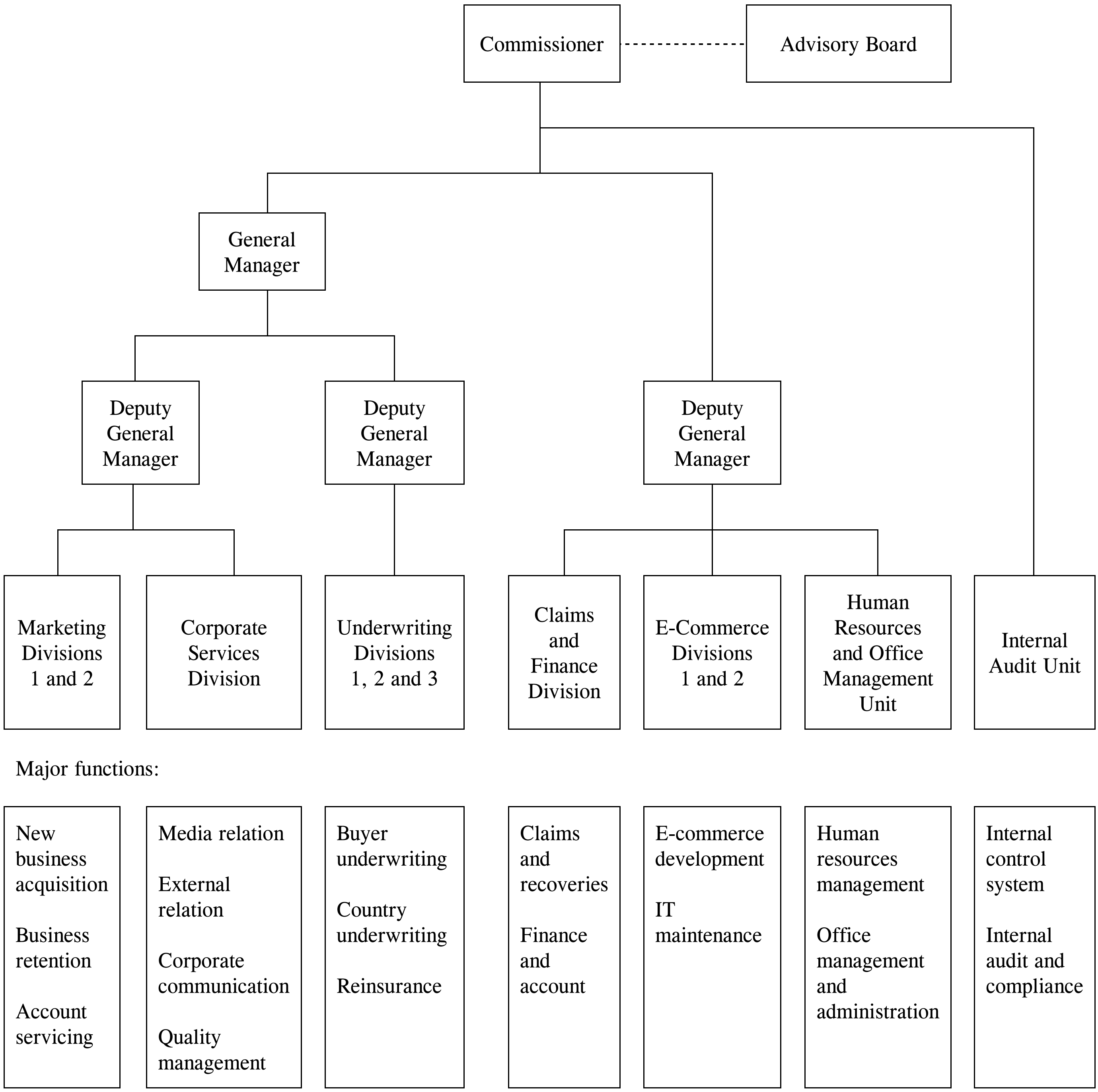
(b) most of the audit recommendations have already been included in the existing manual. For the recommendation on contract commencement date, the ECIC has recently included it in the work manual;

(c) since August 2008, all payments are made to the company accounts of vendors and service providers. To strengthen control, random payment checks are conducted weekly by the Head of the Finance and Account Unit; and

(d) regular briefings on procurement matters have been arranged for staff. The ECIC will continue to ensure that all procurements made are in full compliance with the enhanced procedures.

Appendix A
(para. 1.6 refers)

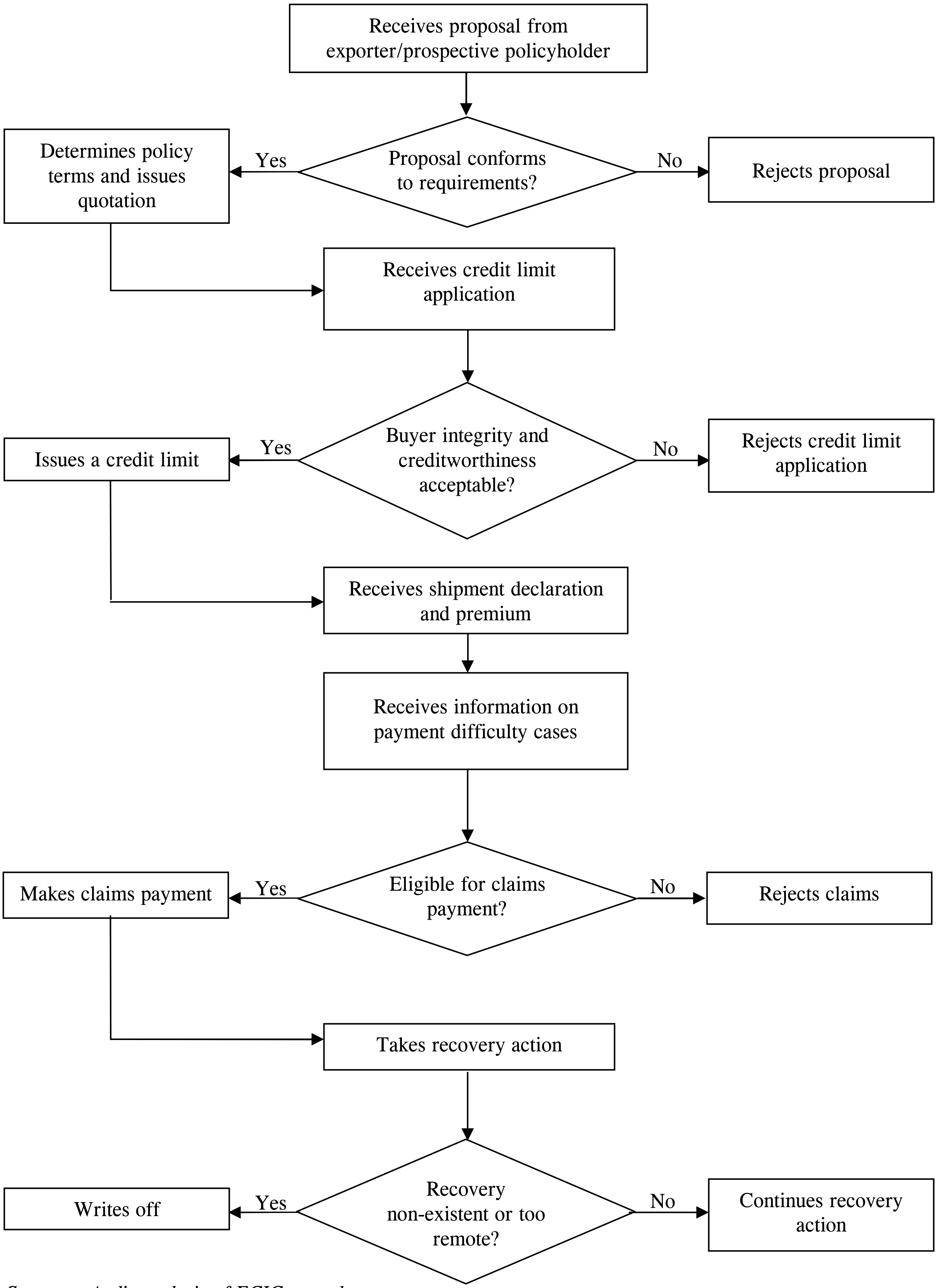
Hong Kong Export Credit Insurance Corporation
Organisation chart
(31 December 2010)



Source: ECIC records

Appendix B
(para. 4.1 refers)

Export credit insurance operations of the ECIC



Source: Audit analysis of ECIC records

Appendix C
(paras. 6.14 and 6.28 refer)

Outsourcing contracts awarded to Company A
(August 2007 to September 2009)

Contract	Contract period	Scope of services	Basis of service charge	Total payment ($ million)
Contract 1 (Note 1)	1.8.2007 to 31.7.2010	Development of computer software and marketing services	Monthly charges based on the number of staff engaged (Note 2)	1.13
Contract 2	1.10.2007 to 31.3.2008	Consultancy service for the development of the Data Warehouse and Business Intelligence Engine Computer Systems	Monthly charges of $40,000	0.24
Contract 3 (Note 1)	1.11.2007 to 31.7.2010 (early terminated on 30.9.2009)	Development of computer software	Monthly charges based on the number of staff engaged (Note 2)	5.74
Contract 4 (Note 1)	1.11.2007 to 31.7.2010 (early terminated on 30.11.2008)	Development of the Data Warehouse and Business Intelligence Engine Computer Systems	Monthly charges based on the number of staff engaged (Note 2)	2.28
Contract 5 (Note 1)	1.11.2007 to 31.7.2010 (early terminated on 31.12.2007)	Marketing services	Monthly charges based on the number of staff engaged (Note 2)	0.23
Contract 6	1.1.2008 to 31.7.2010 (early terminated on 31.3.2009)	Data input and analysis	Monthly charges based on the number of staff engaged (Note 2)	1.41
Contract 7	Contract signed on 31.1.2008 for work to be performed in 20 working days	Consultancy service for the planning of the Data Warehouse Computer System	A lump sum charge of $280,000	0.28
			Total	**11.31**

Source: *ECIC records*

Note 1: *Contract 1, covering different types of work, was split into three separate contracts (i.e. Contracts 3, 4 and 5) on 1 November 2007.*

Note 2: *The charge was made up of the agreed monthly salary cost of individual staff (which included the actual monthly salary and other fringe benefits and staff related expenses) plus a fixed charge of $7,850 per staff.*

Appendix D
(paras. 6.25 and 6.26 refer)

Salary increases of outsourced staff
(August 2007 to September 2009)

Staff	**Effective date of salary increase**	**Elapsed time since last increase** (Month)	**Monthly salary cost borne by the ECIC** ($)	**Percentage of salary cost increase/(decrease)** (%)	**Cumulative percentage of salary cost increase/(decrease)** (%)
Staff 1	1.8.2007 1.10.2007 1.1.2008 1.6.2008	N/A 2 3 5	17,500 21,000 27,150 21,000	N/A 20.0% 29.3% (22.7%)	20.0%
Staff 2 (Note)	1.8.2007 1.10.2007 1.11.2007	N/A 2 1	13,000 15,500 17,500	N/A 19.2% 12.9%	34.6%
Staff 3	1.8.2007 1.10.2007	N/A 2	4,500 7,500	N/A 66.7%	66.7%
Staff 4	1.8.2007 1.10.2007	N/A 2	9,000 11,050	N/A 22.8%	22.8%
Staff 5	1.8.2007 1.10.2007 1.6.2008	N/A 2 8	21,000 23,000 20,500	N/A 9.5% (10.9%)	(2.4%)
Staff 6	1.8.2007 1.1.2008	N/A 5	20,000 27,150	N/A 35.8%	35.8%
Staff 7	1.8.2007 16.1.2008	N/A 5.5	11,500 14,500	N/A 26.1%	26.1%
Staff 8	1.8.2007 1.6.2008	N/A 10	9,500 13,000	N/A 36.8%	36.8%
Staff 9	8.10.2007 1.6.2008	N/A 7.8	12,000 14,500	N/A 20.8%	20.8%

Source: *Audit analysis of ECIC records*

Note: *Staff 2 was also granted an incentive payment of $5,665 in July 2008 for good performance.*

Acronyms and abbreviations

Audit	Audit Commission
CEDB	Commerce and Economic Development Bureau
CLA	Credit limit application
ECIC	Hong Kong Export Credit Insurance Corporation
LegCo	Legislative Council
SME	Small and medium enterprise